



In the Matter of the Appeal Of)
)
ROBERT H. AND CAROLE R. JENKINS)

Kathleen M. Morris
Counsel

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Appeal of Robert H. and Carole R. Jenkins

The issue presented is whether certain distributions made by appellants' wholly owned corporation were taxable dividends or nontaxable loan repayments.

Appellants are the sole owners of Sharmik, Inc., (hereinafter Sharmik), a corporation engaged in the real estate investment business. Sharmik, which was incorporated on June 12, 1970, has never issued any stock. The corporation had no assets until certain real properties and trust deeds were transferred to it by appellants. Sharmik treated these transfers as creating a debt owed to appellants. In addition, appellants paid Sharmik's operating expenses, either directly or by advancing funds to the corporation. These payments were also treated as loans payable to appellants.

By the end of 1970, Sharmik's first year of existence, its records showed a balance owing to appellants of \$26,155.35. A note for that amount payable to appellants was executed on January 1, 1971, by Robert Jenkins, as president of Sharmik. The one-year note was unsecured and had an annual interest rate of one percent.

The above pattern continued during 1971, the year on appeal. Appellants continued to pay Sharmik's operating expenses, to advance the corporation money and to purchase assets for it. Then, in March, April, and May 1971, Sharmik sold several of its assets. The proceeds from these sales were immediately distributed to appellants and credited against the balance due them. There were no other sales by Sharmik during the remainder of 1971, nor were there any further distributions made to appellants. Appellants did, however, continue to pay Sharmik's operating expenses. By the end of 1971, Sharmik's records showed a total balance due appellants for the two years of \$30,749.86, including the unpaid interest on the note. A new note was executed to evidence this balance on January 1, 1972.

Appellants' original 1971 personal income tax return included, as part of their income, \$14,290.03 in distributions received from Sharmik. Appellants paid a tax of \$429.13 with this return. They subsequently paid an additional state tax of \$364.74 as a result of respondent's adjustments based upon a federal audit.

In August 1974, appellants filed an amended 1971 return which incorporated the federal adjustments,

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deleted from their income the distributions from Sharmik and reflected a total tax liability of \$384.09. Respondent treated the amended return as a claim for refund which it denied on the basis that the distributions from Sharmik were taxable as dividends to the extent of Sharmik's earnings and profits. Appellants appealed, claiming the distributions were repayments of loans.

A distribution of money by a corporation to a shareholder with respect to its stock shall be included in the shareholder's gross income to the extent the amount distributed is considered a dividend. (Rev. & Tax. Code, §§ 17321, 17323, subd. (a), and 17383, subd. (a).) The term "dividend" means any distribution of property, including money, made by a corporation to its shareholders out of its earnings and profits of the current year or out of its earnings and profits accumulated after February 28, 1913. (Rev. & Tax. Code, §§ 17381 and 17383, subd. (a).)

Respondent's determination that Sharmik's distributions were dividends taxable as ordinary income is presumed correct unless appellants establish that the distributions constituted loan repayments. In order to do this, appellants must first establish that their advances to Sharmik were, in substance, loans.

It is well settled that the nature of advances to a closely held corporation is a question of fact. (Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957), on remand, T.C. Memo., Jan. 23, 1958, aff'd, 262 F.2d 512 (2d Cir. 1959), cert. denied, 359 U.S. 1002 [3 L. Ed. 2d 1030] (1959); Appeal of Kim Lighting and Manufacturing Co., Inc., Cal. St. Bd. of Equal., June 2, 1969.) The mere form of the transaction is not determinative of this question. (Johnson v. Commissioner, 86 F.2d 710 (2d Cir. 1936).) The taxpayer must show that the characterization he urges comports with "substantial economic reality." (Gilbert v. Commissioner, supra.)

When attempting to establish the nature of advances to a closely held corporation, the basic inquiry is whether the funds were placed at the risk of the corporate venture or whether there was a reasonable expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, supra; Appeal of Kim Lighting and Manufacturing Co., Inc., supra.) The federal courts have developed numerous guidelines for answering

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this "debt versus equity" question. (See generally Holzman, The Interest-Dividend Guidelines, 47 Taxes 4 (1969).) Of the many factors considered by the courts, six are particularly pertinent in this case. They are: (1) "thin" or adequate capitalization; (2) an identity of interest between creditor and stockholder; (3) the likelihood that an independent lender would have made loans to the corporation; (4) the presence of normal creditor safeguards; (5) the failure of the debtor to repay on the due date; and (6) the anticipated source of repayment.

Reviewing the facts, we see that this is not a case of "thin" capitalization, but rather of no initial capitalization at all. This fact coupled with the fact that appellants, who are Sharmik's sole owners, made all the advances themselves is a strong indication of equity capital contributions rather than loans. (Tomlinson v. The 1661 Corporation, 377 F.2d 291 (5th Cir. 1967).) The facts above leave little doubt that a reasonable independent creditor would not have made such loans to an uncapped corporation. This gives rise to an inference that appellants' advances were not loans, but were, in fact, equity contributions. (Estate of Nixon v. United States, 464 F.2d 394 (5th Cir. 1972).)

It is also important that no notes were executed at the time the advances were made. Instead, a single note was executed at the end of each year. The notes themselves lacked the normal creditor safeguards in that they bore interest at the nominal rate of one percent per year and they were unsecured. Additionally, the one-year maturity date on the notes has been ignored, and the interest has not been paid; each year a new note is executed for an even larger amount, including the unpaid interest. These are not the characteristics of a true debtor-creditor relationship. Rather, they are a strong indication that the funds were placed at the risk of the corporate venture. (Curry v. United States, 396 F.2d 630 (5th Cir. 1968).) This conclusion gains support from the fact that payments were made only when there were proceeds from the sale of Sharmik's assets. Furthermore, it is apparent that repayment was dependent on Sharmik's ultimate success, an additional characteristic of an equity contribution. (Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959), cert. denied, 359 U.S. 1002 [3 L. Ed. 2d 1030] (1959).)

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Under these circumstances, we can only conclude that as a matter of "substantial economic reality" appellants' advances were placed at the risk of the corporate venture and constituted capital contributions rather than loans. Consequently, the distributions made by Sharmik **were** taxable dividends, to the extent of Sharmik's earnings and profits, rather than nontaxable loan repayments.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the **action** of the Franchise Tax Board in denying the **claim** of Robert H. and Carole R. Jenkins for refund of personal income tax in the amount of \$409.78 for the year 1971, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day
of May , 1977, by the State Board of Equalization.

William B. Bernick Chairman
Paul H. Hearn Member
George J. Hearn Member
Les S. Hearn Member
_____, Member

ATTEST: *TO TO Bell*, Executive Secretary